Ravi Menon: Asia – no room for complacency

Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Paris Europlace Financial Forum, Singapore, 30 November 2011.

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Mr Christian Noyer, Governor of Banque de France,

Distinguished guests,

Ladies and gentlemen,

Good morning. For those of you who are coming from abroad, a warm welcome to Singapore.

Deleveraging out of a debt overhang

Molière, a French playwright considered to be one of the greatest masters of comedy, once offered this sobering thought: "*Debts are like children; begot with pleasure and brought forth in pain*". Today, the pain he described is palpitating throughout the world and keeping many leaders in government, business, and finance awake at night.

The advanced economies are awash in debt. Governments, households, and banks must reduce leverage to restore economic and financial sustainability. But history tells us that deleveraging, while necessary, leads to a prolonged period of slower growth punctuated by increased financial market volatility.

The gross government debt-to-GDP ratio is 80% in the UK and in the Eurozone, 100% in the United States, and 230% in Japan. Sovereign debt in aggregate is today at levels not seen since the Second World War. Financial markets, which had hitherto tolerated the build-up in debt, have turned merciless against the Eurozone economies, driving up sovereign spreads and dragging down the ratings of those who hold sovereign paper. European governments have begun to take steps towards fiscal consolidation, and must convince markets that these steps are credible.

Unfortunately, the private sector is not ready to take over the slack in public demand. Private sector debt-to-GDP ratios exceed 250% in the G3 economies. In the United States, where the household debt-to-disposable income ratio reached an unprecedented 135% in 2008, deleveraging is already underway with the recovery in private consumption well below historical rebounds. While Eurozone households are less leveraged than US households, disposable income is likely to grow more slowly in the Eurozone and hence be a bigger drag on consumption.

A third source of deleveraging is the banking system. Banks in the Eurozone have to strengthen their capital adequacy position to meet new regulatory requirements as well as buffer against potential losses on their sovereign debt holdings. With uncertain prospects for raising fresh capital in equity markets and facing funding shortages in wholesale markets, some of them are looking to scale back their risk-weighted assets. The resultant crunch in credit could further exacerbate the slowdown in the economy.

With governments, households, and banks all having to deleverage at the same time, we are looking at a prolonged period of sub-par growth in the advanced economies. In many advanced countries, debt-to-GDP ratios are not expected to stabilise until 2015 to 2020.

Asia: neither decoupled nor derailed

What does deleveraging in the G3 mean for Asia? Asia is not immune to developments in America or Europe. There are two channels through which the effects of deleveraging will be transmitted to Asia: financial and trade.

The financial channel could see several global banks operating in Asia downsize their assets. The areas more likely to be affected are trade financing, project financing, asset leasing, SME lending, and syndicated lending. No doubt, some Asian banks will step up and fill some of these gaps. But it is unlikely that there would be full substitution. The resultant tightness in credit could lead to a slowdown in economic activity.

The trade channel could see transmission through a slowdown in exports to the US and Europe as consumption and investment in the latter become weaker.

- According to the ADB, 60% of sales from developing Asia are to the G3 economies.
- According to the IMF, if growth in the EU declines by 3.5% points below the baseline for two years, growth in Asia will decline 1.5–4.0% points below the baseline.
- Taking the perspective from Singapore, Europe is also one of our largest trading partners and source of investment.

A scaling back of global risk appetite precipitated by slower growth in the G3 will dampen consumer and business sentiment in Asia generally.

In short, Asia is not decoupled from America and Europe. But while Asia is not decoupled, it will not derail either. Growth will slow but will not stall. Asia is entering the current downturn from a position of strength.

- Public finances are healthy. Fiscal deficits in emerging Asia are 2–3% of GDP.
- The debt burden is low. Public sector debt ranges from about 25% to 55% of GDP. External debt is about 30% of GDP.
- Official foreign reserves are healthy.
- The banks are well-capitalised. The 25 largest Asian banks comfortably meet Basel III Tier 1 capital adequacy ratios.
- Governance is stronger. Stronger regulatory frameworks and corporate governance reforms following the Asian financial crisis in 1998 have improved the resilience of the financial and corporate sectors.
- There is policy flexibility on the fiscal, and to some extent, monetary fronts, in the event global growth slips more than expected.

Notwithstanding emerging Asia's strong fundamentals, there is no room for complacency. The region is not without significant challenges which, if unaddressed, will prevent it from realising its potential and render it more vulnerable to shocks from the advanced economies. Let me highlight three medium-term imperatives for emerging Asia.

Increasing domestic demand

First, Asia must increase domestic demand. As growth slows in the advanced economies, it is in the region's interest to reduce reliance on external demand and develop indigenous sources of growth. This will help to strengthen and stabilise Asian economies over the longer term. If an increase in domestic demand in Asia is complemented by fiscal consolidation in the key industralised economies, a longer term rebalancing of global demand could be achieved.

Demographic factors will work to increase domestic demand in Asia. As the populations in the surplus economies of Asia age and begin to consume more, a structural factor contributing to the present imbalances will diminish in importance. But demographic transitions take time and it is in Asia's, and the rest of the world's interest to step up reforms to boost domestic demand. Policy-led efforts in China to reduce precautionary savings and spur consumption through pension reforms are a good start. Real exchange rates in Asia must appreciate, to spur resource allocation to the non-tradeable sector of the economy.

Managing capital flows

Second, Asia must learn to manage volatile capital flows. Low interest rates in the advanced economies since 2008 have prompted global investors to seek higher returns in emerging economies, especially Asia. Gross capital inflows into developing Asia during 2009–2010 amounted to some US$1.2 trillion, nearly 6% of GDP. Several Asian economies experienced record-high portfolio inflows. Capital inflows are unlikely to persist at the volumes seen in the last two years, as monetary policy settings in the advanced economies are eventually normalised.

But there are longer term structural factors that will drive capital flows from advanced economies to emerging Asia, namely the superior growth prospects in Asia and a diversification in global portfolios towards higher yielding Asian assets. Advanced economies represent half of global GDP but three-quarters of global market capitalisation in equity markets. A reallocation of just 5% of advanced economy equity portfolios to emerging economies translates into a potential flow of US$2 trillion per year. So, the phenomenon of large capital inflows into Asia is here to stay and we should learn how to handle it.

Large capital inflows pose two risks. First, these flows can potentially overwhelm Asia's ability to channel them to productive use, and create asset market bubbles – especially in real estate. Residential property prices in some Asian markets have increased by more than 50% since 2009, outpacing income growth. To be sure, there are underlying structural factors supporting housing demand, such as urbanisation, growing populations, and the rise of the middle class. But surplus liquidity and rapid credit expansion fuelled by low global interest rates and large capital inflows have exacerbated asset price inflation in Asia. The unwinding of asset bubbles can be rapid and extremely unpleasant.

Second, large capital inflows can turn into sudden outflows. Sharp capital flow reversals can cause exchange rates to weaken, trigger panic in funding markets, and even result in destructive wealth effects. The unwinding of long positions in Asian markets as global investors sought to de-risk their portfolios was partly responsible for the sharp selloff in many Asian currencies in recent months.

The most effective way to manage capital inflows is to allow interest rates or exchange rates to go up so that capital is priced appropriately. Indeed, as emerging Asia continues to grow, allowing the exchange rate to steadily appreciate over the medium term is vital to ensuring that capital inflows are moderated and allocated to productive investments.

But interest rates and exchange rates cannot shoulder entirely the burden of adjustment to large and volatile capital flows. Asian countries have been experimenting the use of so-called macroprudential tools to complement the more traditional macroeconomic tools in dealing with capital flows and asset price inflation. These include the use of loan-to-value ratios, taxes and stamp duties on asset market transactions, and minimum holding periods for assets, all of which serve to dampen demand for domestic assets. Asia needs to continue refining these tools, learning from experience and adapting to different circumstances.

Deepening and broadening financial markets

Third, Asia must deepen and broaden its financial markets. Asia must do a better job in effectively intermediating its considerable savings pool as well as capital inflows towards

more productive investment in the region. Deeper financial markets will help to absorb or redeploy more effectively capital from abroad. Broader financial markets will help minimise the flow of capital to unproductive investments by offering a wide range of investment instruments.

The ADB has estimated that some US$8 trillion will be needed in Asia to finance infrastructure projects through 2020. Capital markets provide an efficient way to intermediate flows and can reduce the cost of borrowing. In fact, the financing needs of Asia – in infrastructure and other high fixed capital investments – are particularly amenable to capital market solutions, given the size of the financing tranche and the need for credit risk diversification. Moreover, as banks deleverage – pressed by the new Basel III capital rules – financing through the capital markets will allow businesses to directly access the large savings pool in Asia for funding.

Conclusion

Let me conclude.

The Asian growth story remains intact. It is not a foregone conclusion, many things can go wrong, but the odds are that emerging Asia will remain the fastest growing region in the world. But most of Asia is still relatively poor in per capita terms, its financial markets are still under-developed, and it lacks truly global businesses.

Europe may be beset with economic uncertainties but European companies remain among the most dynamic, most technologically advanced, and most global businesses in the world.

Together – Asian economies and European corporates – can create opportunity and prosperity.

European firms can promote long-term capital investment into Asia and provide expertise in niche sectors, such as in shipping, aviation, and sustainable finance. For European financial institutions, emerging Asia represents an enormous growth opportunity. Many European corporates are expanding their footprint in Asia as Asia becomes an increasingly important source of revenue. For financial institutions, this is even more relevant because banking is about relationships – though thick and thin – and global financial institutions play a key role in financing the needs of businesses in Asia. European banks currently account for 11% of banking system assets in ASEAN, according to estimates by Deutsche Bank, and French banks, for instance, play an important role in commodities trading and infrastructure financing in Asia.

At this critical moment in the global economic conjuncture, we in Asia wish our European friends well. The challenge before them is enormous. Europe needs to reduce its debt and grow at the same time. This will require restructuring its economy to become more productive and reforming its social structures to reduce the burden on the state. But Europe has much going for it – a talented people, strong institutions, world-class companies, advanced technology, and large, integrated markets. With the right policies and strong leadership, you will succeed.

As Jacques Cousteau, the famous French explorer, said: "*If we were logical, the future would be bleak, indeed. But we are more than logical. We are human beings, and we have faith, and we have hope, and we can work.*"

I wish you fruitful discussions. Thank you.